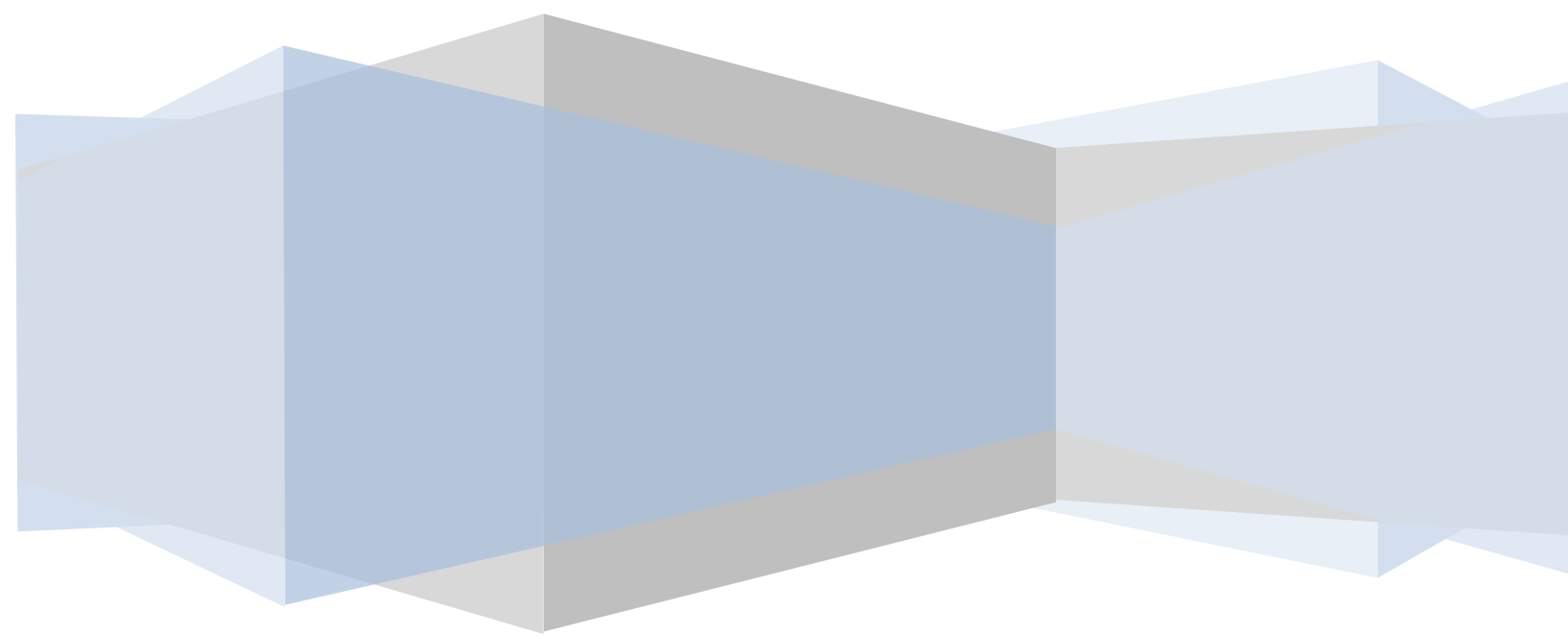

GEORGIA PERFORMANCE STANDARDS

Unit 6: “Let’s Make It Personal”



**Georgia Council on
Economic Education**



GEORGIA PERFORMANCE STANDARDS

SSEPF2 The student will explain that banks and other financial institutions are businesses which channel funds from savers to investors.

a. compare services offered by different financial institutions

b. explain reasons for the spread between interest charged and interest earned

Banks are businesses, and as such, their goal is to maximize profits. Banks pay depositors interest as an incentive for depositing their money in their specific institution. The bank then loans that money to others and charges them a higher interest rate for the use of the funds. The difference between the interest charged to borrowers and the interest paid to depositors (minus expenses) is profit.

c. give examples of the direct relationship between risk and return

Risk describes a situation in which the outcome is uncertain and a range of results, potentially both good and bad, is possible. The greater the range of possible outcomes, the greater the risk. For example, imagine two investment strategies, both with the same cost. The first strategy has a one-third chance of making profits of \$9 million, a one-third chance of making profits of \$10 million and a one-third chance of making profits of \$11 million. The second strategy has a one-third chance of making losses of \$5 million, a one-third chance of making profits of \$10 million and a one-third chance of making profits of \$25 million. In both cases, the average or expected outcome is \$10 million. But the first strategy has less risk, because the range of possible outcomes is grouped more closely together.

The return of an investment is calculated as the income or profit generated by that investment divided by the original cost of the investment. The rate of return is usually expressed as a percentage over a year. If you put money in a bank account and receive a 3 percent rate of interest, then the return is 3 percent. A more complex example would be if you invest money in a stock which pays a dividend and also increases in value per share. The total increase in value, including both dividend and the rise in the share price, would be counted in the rate of return. Additionally, if after purchasing a stock it's per-share price drops below the purchase price it will have a negative rate of return. Firms need to make projections about rate of return when they make decisions about building a new plant, buying a large piece of equipment or launching a new product. They calculate the additional profit that they expect to earn from the business decision, divided by the cost of that decision.

There is a strong relationship between risk and return. Generally, the greater the risk, the higher the potential return. If an investment seems too good to be true, it probably is.

d. evaluate a variety of savings and investment options, including stocks, bonds and mutual funds.

Stock

An ownership share or shares of ownership in a corporation.

Bond

A certificate of indebtedness issued by a government or a publicly held corporation, promising to repay borrowed money to the lender at a fixed rate of interest and at a specified time.

Mutual Fund

A pool of money used by a company to purchase a variety of stocks, bonds or money market instruments. Provides diversification and professional management for investors.

SSEPF4 The student will evaluate the costs and benefits of using credit

a. list factors that affect credit worthiness

Creditworthiness is the extent to which a person is deemed suitable to receive credit, especially as shown by reliability in repaying loans in the past. For example, if you do not have enough money of your own to open a videogame store, what alternatives do you have? If you believe you can easily borrow the money you need from a bank, you are probably wrong. People who want to open new businesses often have trouble obtaining credit from banks. Banks lend money if they are quite sure the money will be repaid. They usually require a pledge of assets or collateral to back up a loan. The collateral must be as much as or more than the amount of money lent. Entrepreneurs who own assets like expensive homes or land are able to borrow needed funds when they pledge their property to the bank. A person who lacks such assets will not be able to borrow much money through a conventional bank loan. To be able to borrow money, an individual or a firm must be able to show credit worthiness, that is, the ability and willingness to carry the cost of borrowing.

b. compare interest rates on loans and credit cards from different institutions

Banks, credit unions, savings and loans associations and other institutions are profit motive driven businesses. As such, they charge different interest rates on loans and credit cards in an effort to attract customers. As a consumer would compare prices on groceries, clothing, a haircut, restaurants and other goods and services, a consumer should also compare interest rates when shopping for a loan or a credit card.

c. explain the difference between simple and compound interest rates.

Imagine that last year you invested \$100 and receive a rate of return after one year of 10 percent, so that you have a gain of \$10. You now invest your total, the \$110, and receive a rate of return of 10 percent, but at the end of this year your gain is not \$10, but rather \$11. The rate of return hasn't changed, so why was the gain \$10 last year and \$11 this year? The answer is that when you reinvest past earnings, then in the future you will earn

interest not only on the original investment, but also on the past accumulated returns; this is called compound interest.

The formula for compound interest, showing how much will accumulate by a certain time in the future given the original amount invested and the annual rate of return, is as follows: $Original\ investment(1 + rate\ of\ return)^{number\ of\ years} = future\ value$

Thus, making a one-time investment of \$1,000 and letting an 8 percent annual return on this investment compound for 40 years would give a future value of $\$1,000(1 + .08)^{40} = \$21,724$. One lesson of compound interest is to try to save relatively early in life for retirement, because saving in your 20s and 30s allows much more time to accumulate and thus to let the power of compound interest work than saving done in your 50s or 60s.

SSEPF5 The student will describe how insurance and other risk-management strategies protect against financial loss.

a. list various types of insurance such as automobile, health, life, disability and property

Insurance is a practice or arrangement whereby a company provides a guarantee of compensation for specified forms of loss, damage, injury or death. People obtain such guarantees by buying insurance policies, for which they pay premiums. The process allows for the spreading out of risk over a pool of insurance policyholders, with the expectation that only a few policyholders will actually experience losses for which claims must be made. Types of insurance include automobile, health, renter's, homeowner's, disability and life.

Type of Insurance	Purpose	Examples of Coverage
Automobile	Provides financial protection from losses due to an auto accident or other damage to a car.	Collision: provides for the repair or replacement of the policy owner's car damaged in an accident Liability: covers the cost of property damage or injuries to others caused by the policy owner Comprehensive: covers the cost of damage to an auto as a result of fire, theft, or storms
Health	Provides payment for certain health-care costs.	Basic Health: covers office visits, laboratory, hospital costs and routine care Major Medical: protects against large bills from catastrophic illness or injury Dental and Vision: covers some cost of routine exams and specific services
Renter's	Provides financial protection in case of loss of personal possessions in a rental unit.	Reimburses policy owner for loss of possessions in a rental unit due to fire, theft, water damage, etc.
Homeowners	Protects against financial loss from damage to your home or its contents, as well as injury to others on the property.	Physical Damage: reimburses for fire or water damage to house or other structures on the property Loss or Theft: reimburses for personal property damaged or stolen Liability: Protects against loss from a lawsuit for injuries to invited or uninvited guests
Disability	Provides income over a specified period when a person is ill or unable to work	Policy owner selects a replacement income for lost wages if an illness or accident prevents the person from working. Disability income is paid for a specified time after a waiting period.
Life	Provides financial protection to dependents of policy owner when policy owner dies.	Term Life: Offers protection for a specified period of time Whole Life: Offer protection that remains in effect during the lifetime of the insured and acquires cash value

b. explain the costs and benefits associated with different types of insurance

The purchase of insurance involves paying an amount called a premium at regular intervals, with the understanding that if negative events occur, the insurance company will pay certain costs. For example, health insurance provides payments to health-care providers if you are sick. Life insurance provides a payment to your descendants if you die. Car insurance provides payments for damages caused in an auto accident. Homeowner's insurance pays for home repairs in the case of fire or storm damage.

Insurance works on the principle that in a large group of people historical experience allows one to predict with some accuracy how many of them will suffer a negative event each year--but no one can say in advance exactly who in the group will suffer the negative events. Individuals who are averse to taking risks prefer to pay an insurance premium, and be protected against the high costs of negative events, instead of waiting to find out if they are unlucky enough to suffer the negative events. The great irony of insurance is that it is a purchase one hopes never to benefit from--since that would mean that the negative event has occurred.